STATEMENT OF JOHN W. SNOW, DEPUTY UNDER SECRETARY, U. S. DEPARTMENT OF TRANSPORTATION, TO THE HOUSE COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION, SUBCOMMITTEE ON AVIATION, CONCERNING AVIATION REGULATORY REFORM, MAY 11, 1976

Mr. Chairman and Membersof the Subcommittee:

I appreciate the opportunity to be here and to discuss aviation industry regulatory reform. This is one of the most important and controversial questions facing the aviation community today. It would not be an exaggeration to say that we are at a watershed for aviation regulation. I shall first describe the bill proposed by the Administration and then spend the remainder of my time discussing some of the allegations made by its opponents.

The present system of airline regulation is seriously deficient. Its most serious deficiency is that it causes air fares to be considerably high than they would be otherwise. It also results in a serious misallocation of resources; it discourages service innovations; it denies consumers the range of price and service options which they would prefer; and it creates a chronic tendency towards excess capacity in the industry.

The Civil Aeronautics Board (CAB) has historically used its broad powers to forbid competitive pricing and lower fares. Unable to compete on the basis of price, carriers have been forced into costly service competition, services whose costs have been passed on to the consumer.

On review of the evidence, one is forced to conclude that the present regulatory system is hindering, not advancing, the original statutory objectives of "adequate, economical and efficient service by air carriers at reasonable charges. The present regulatory system has become a major obstacle to the provision of air service at the lowest cost consistent with the furnishing of such service." Ironically airline profit levels are not increased, and may indeed be made more volatile than otherwise, by this regulatory system.

These defects result from the policies the CAB has adopted with respect to entry and pricing. They flow naturally from the artificial suppression of competitive market forces. The deficiencies can only be corrected by modification of the present regulatory system to allow wider operation of competitive market forces. The most pressing problems in the airline regulatory field cluster in two broad areas: pricing flexibility, market entry. Anticompetitive agreements must also be prohibited.

Only through fundamental changes in the present law with respect to these matters will the airline industry be able to operate in a workable competitive fashion. Only be allowing the industry to operate in this fashion will the basic defects of its performance be corrected.

Pricing

The Aviation Act is designed to obtain the increased pricing flexibility that is essential to improving the performance of the aviation industry.

Under the bill, carriers would be given substantially more freedom to increase or reduce fares from the fear of suspension. In addition, explicit time limits will be placed on Civil Aeronautics Board action in fare cases, and management will be given much greater freedom to reduce rates without fear that the rate reduction ultimately will be found unlawful.

The Civil Aeronautics Board's power to suspend or set air fares is statutory. The Federal Aviation Act of 1958 requires air carriers to file and observe just and reasonable tariffs. If the Board finds a rate unjust, unreasonable, unjustly discriminatory, unduly preferential, or unduly prejudicial, it may suspend the tariff. After investigation, the Board may determine and prescribe a different fare, or maximum or minimum charges, or both.

Under the statute, carriers are free to file fares with the Civil Aeronautics Board which are different from those of their competitors, and this might be thought to create considerable pricing competition. As a practical matter, however, there is little real price competition. Airline fares have been generally uniform in all markets of equal distance, regardless of costs, supply, seasonality or traffic density. The only important exception is that the Board has given local service carriers the right to charge 130% of the formula fare -- but only where they are monopolists!

Carriers who file tariffs reflecting moderate price decreases for particular types of service have had to answer to competing carriers who have generally complained to the Board that the rate reduction is unreasonably low. The cost, the uncertainty, and the delay of Board suspension proceedings has had a chilling effect upon individual carrier ratemaking initiatives. Because carriers anticipate the difficulty of obtaining approval, many reductions are never filed in the first place.

The Board's use of industry average costs and of an assumed demand elasticity equal to less than unity for all traffic for all rates leads to an upward bias in fare determination. The details of this bias were discussed in Secretary Coleman's extended testimony and need not be repeated now. Suffice it to say that the Board's actions have caused fares to be too high and that this bias is a natural result of the kind of price regulation the Board feels it must use.

The Aviation Act of 1975 is designed to increase carrier pricing flexibility by reducing the regulatory hurdles to innovative pricing.

First, it would amend section 1002(d) to provide that a rate above "direct costs" may not be found unjust or unreasonable on the basis it is too low. Direct costs are defined as those costs which vary directly with output, i.e., to exclude overhead, fixed costs, and non-variable costs. By limiting the Board's minimum ratemaking authority in this way, the Act provides for considerable downward pricing flexibility. The Board's present authority with respect to the ultimate lawfulness of rate increases is not affected.

Second, the Act amends section 1002(g) to create a no-suspend zone. The Board's ratemaking procedures have two parts: a suspension proceeding and a hearing as to ultimate lawfulness. After a rate is introduced, the Board can "suspend" the rate pending a full hearing. Suspension, however, does not mean that the rate will ultimately be found to be unlawful. It simply postpones the effective date of the rate. If the rate is suspended, the Board then proceeds to a hearing, and it is at this hearing that the lawfulness of the rate is decided. Although the suspension proceeding does not decide the ultimate lawfulness of a rate, it does add to the regulatory lag. It is almost certain that an innovative rate will be suspended, and this denies the carrier the ability to respond quickly to changing markets. Also if a rate is suspended, it means that the hearing cannot be based on actual experience, but must be based on hypothetical assumptions of the consequences of putting the rate into effect. To reduce this lag and to ensure that hearings are based on fact, the bill proposes substantial restrictions on the present suspension procedures.

Rate increases under our bill may be suspended but only if they exceed ten percent of the rate in effect one year prior to the proposed change. Rate decreases may be suspended but only if there is a clear and convincing reason to believe that they do not cover the direct costs of the service at issue or if the resulting rate decrease exceeds certain limits. In the first year after enactment, the Board may not suspend a rate which provides for less than a twenty percent decrease in the rate in effect on the date of enactment; and in the second year after enactment, the Board may not suspend a rate which provides for less than a 40 percent decrease in the rate in effect on the date of enactment. During the third and succeeding years, the Board can not suspend any proposed rate reduction unless there is clear and convincing evidence to believe on the basis of a preliminary finding that the rate was likely to be below operating costs. The direct operating costs criterion is a protection against predatory pricing. I want to emphasize that this zone relates only to suspensions, and does not affect the Board's authority to rule on the ultimate lawfulness of a rate.

The Act also amends 1002(e) to place increased emphasis on the need for price competition as a means of promoting a healthy air transportation industry responsive to the public needs. Finally, the Act provides a time limit for rate cases. If the Board has not completed its proceedings within 180 days of the time the rate was scheduled to take effect, the tariff goes into effect and is deemed lawful without further proceedings.

The foregoing changes in the Aviation Act will create considerable opportunities for increased pricing flexibility. I should also add that a key feature of the bill just introduced by Senator Kennedy is also an increase in pricing flexibility. Pricing flexibility is a necessary condition to improve the performance of the airline industry. Problems of excess capacity, high air fares, and the narrow range of price service options are directly related to the absence of effective price competition in the airline industry. In intrastate markets, such as Texas and California, where entry and pricing have been less restricted, prices have been considerably lower than in comparable interstate markets. The Secretary gave extensive testimony on this subject, and I shall revert to it again later when dealing with the airlines' objections to these comparisons. Commuter airlines, operating completely free of controls over entry and price, and using equipment which is more mostly per passenger mile, tend to charge comparable or lower fares than regulated carriers on flights of similar distance.

Entry

The Federal Aviation Act grants the Board wide discretion in determining entry and route awards. Under section 401 of the Federal Aviation Act, the Board is given authority to determine which carriers may operate in scheduled interstate service and on which routes they may operate. The applicant must be found fit, willing and able to perform the service properly and the transportation must be required by public convenience and necessity. The Board has interpreted the entry provisions of the Act so as to create unnecessarily high barriers to entry into the industry. Reducing the barriers to entry into the commercial aviation business is a second essential condition to improving its performance.

Moreover, increased pricing flexibility and liberalizing entry go hand-in-hand. Thus any proposal relating to price must be combined with one relating to entry into air transportation markets. The indivisibility of these two regulatory reforms has been discussed by Secretary Coleman. The present system of blockaded entry reduces the pressure on existing carriers to price competitively. This, in turn, contributes to the problem of high fares, low load factors and excessively high costs. As the Board's staff has correctly pointed out in their excellent study, which is referenced in the Secretary's statement, with the number of competitors essentially fixed, maximum fare and minimum quality of service regulation may become necessary. But with liberalized entry and pricing, carriers will be under competitive pressure to provide a range of services desired by the public at prices which reflect the actual cost of producing the service without maximum fare regulation. The threat of potential competition will police carrier behavior and provide the needed incentive for carriers in existing markets to keep prices at a level low enough to forestall entry of competitors. Potential competition is a vitally important force in producing desirable market results, i.e., in assuring that firms are diligent in providing the type of service and price/quality options that the public desires.

Relaxation of entry is essential to police the pricing flexibility provisions of the Aviation Act. Pricing flexibility unaccompanied by entry relaxation as desired by airlines would create a serious danger of higher fares, exacerbation of the over-capacity problem and an even poorer economic performance by the airline industry.

The Aviation Act of 1975 is designed to substantially reduce the barriers facing qualified firms who wish to enter into air transportation, expand into new markets, or offer new varieties of service. Enactment of the legislation, however, would not necessarily lead to the addition of new carriers on each domestic route, nor even to the addition of new carriers on a majority of the deomestic routes. The basic result would be the introduction of potential competition. The liberalized entry will place firms at the edge of the market, able and ready to step into that market when consumers are dissatisfied with the existing service and price levels. Such dissatisfaction would attract new entrants, and the existing firms will have an incentive to price competitively and offer the type of price service options which consumers desire. Certainly there will be occasions when an outsider will come into the market. This will occur where the new entrant provides a type of service not available from existing carriers and in instances where the new firm is simply more efficient than existing firms. The more important result, however, will be introduction of potential competition which in turn will produce more competitive results by existing firms. The proposed Act contains a number of provisions designed gradually but substantially to reduce the barriers to entry into air transportation while providing adequate time for existing carriers to rationalize their operations and adjust to the changing economic environment. I will outline the Act's major entry provisions.

First: Policy Changes. The Board's present Declaration of Policy written some 38 years ago, was framed in the context of an infant industry in need of protection rather than a mature industry capable of operating in a competitive environment. The Board has, in the past, relied on its Declaration of Policy to limit competition. In contrast, the Aviation Act of 1975 proposes to revise this Declaration to stress the desirability of competition and to deemphasize the protection of established carriers. The bill proposed by Senator Kennedy has a similar provisions and Mr. Robson's testimony before the Senate Subcommittee indicates that the CAB also favors this change in the law. I might add that the Kennedy bill also contains many of the other Administration proposals with respect to entry. I would also add that we are submitting a clarifying amendment to our proposed Policy Declaration that directs the Board to take into account any special factors or circumstances that it finds affects foreign air transportation.

Second: Procedural Changes. The Board has often refused to hear applications and to render decisions within a reasonable period of time -- a violation of the present Federal Aviation Act which requires that applications be set for hearing and that the issues be resolved "as speedily as possible." It has been able to do so by using procedural motions to settle substantive questions -- thus avoiding judicial review. The Aviation Act of 1975 deals with these matters by proposing procedural changes which would ensure that the Board complies with the already existing requirement to hear and decide cases speedily. To speed the disposition of cases the Board will be given the option of dismissing any cases it chooses not to hear. However, any cases dismissed shall be dismissed for cause and will be reviewable by the Court of Appeals -- thus ending the practice of denying applications by inaction and leaving the applicant with no recourse to court review.

Third: Certificate Restrictions. Over a period of years, the Board has attached numerous types of conditions and restrictions to the operating certificates held by air carriers. Viewed as a comprehensive whole, the primary effect of these restrictions is to protect the markets of established air carriers by preventing other carriers from offering services they would like to provide. These operating restrictions have a particularly pernicious effect: they increase the operating costs (and/or decrease revenues) of the restricted carrier. Consequently they permit its competitors to either operate inefficiently, or become poor marketers, or to earn monopoly profits. The Secretary gave many examples of these restrictions.

The Aviation Act of 1975 directs the Board to undertake a proceeding to eliminate all existing certificate restrictions within a five year period and specifically prohibits the Board from imposing any closed-door, single-plane service, mandatory stop, long-haul, or any other similar restrictions. In phasing out existing restrictions, the Board would be directed to proceed carefully with an eye toward the effects on the carriers and the traveling public. The phasing of the restriction removal program is dictated by the desire to provide all existing carriers with adequate opportunity to increase their efficiency and adjust their operations to the requirements of a more competitive environment.

Fourth: Supplemental vs. Scheduled Service. For years doubt has existed as to whether paragraph 401(d)(3) of the Federal Aviation Act was intended to prevent supplemental carriers (i.e., charter carriers) from also applying for authority to provide scheduled service. The Board has recently addressed this question and decided that a supplemental carrier could not hold operating authority as a scheduled carrier. Partly as a result of this legal ambiguity, no supplemental carrier has ever been permitted to undertake scheduled service even though qualified in every other respect. The Aviation Act of 1975 would amend paragraph 401(d)(3) so that supplemental air carriers would be allowed to apply for authority to provide scheduled service. This provision is important because it places at the edge of the market a group of carriers that are clearly fit, willing and able to provide airline service. I am happy to note that Mr. Robson favored this provision.

Fifth: Charter Service: In the past, the Board has generally placed such strict limitations on charter services that its growth has been impaired.

Legislation presently before Congress (S. 421 and H. R. 6625) would substantially broaden the availability of charter services. In response to this legislation and substantial public criticism, the Board has recently expanded charter availability on its own initiative (Part 378(a), effective September 13, 1975). The Aviation Act of 1975 incorporates the essential features of S. 421 and H. R. 6625 in order to guarantee the continued availability of charger services which are not unduly restricted. The liberalizing of charter rules is important for two reasons. First, there is no good economic reason to inhibit the provision of service which people are willing to buy and which can profitably be provided. Second, the availability of charges as a viable alternative to travelers will provide a further competitive check on the prices charged by airlines.

Sixth: Unserved Markets. Under present law, a Board finding of public convenience and necessity is required even though the applicant is otherwise fit, willing and able to serve a particular market and service is not being provided by established firms. When qualified firms are prevented from offering service which established firms are not willing to provide, no useful function is served -- not even the dubious function of protecting existing frims except insofar as their less desirable, round-about or indirect service may be protected. The Aviation Act of 1975 deals with this problem by requiring the Board to grant approval for qualified applicants wishing to provide non-stop service between points not receiving such service from certificated carriers.

Sixth: Liberalized Exemptions. In 1952 the Board exempted operators of small aircraft from the detailed economic regulation administered by the Board. So long as they operated aircraft smaller than that 12,500 pounds (approximately 19 seats), commuter air carriers were free to charge whatever price they wished to set and to operate where and when they chose. In 1972 the Board increased the exemption to 30 passengers or 7,500 pounds of payload.

The Aviation Act of 1975 would liberalize the exemption from 30 seats to 55 seats. This provision will enable commuter carriers to purchase larger turbo-prop pressurized aircraft and should materially expand their scope of operations. It will enable these carriers to improve service to small points not attractive to certificated carriers and foster the development of new aircraft in the 30 to 55 seat range.

Seventh: Sale of Certificates. The Aviation Act of 1975 provides that, after January 1, 1978, a carrier may sell, transfer, or lease any portion of its operating authority to another carrier so long as the purchaser is fit, willing and able to undertake the transportation and so long as the transfer does not diminish competition. In effect, this provision provides an alternative to the normal public convenience and necessity entry route for qualified air carriers.

This provision provides carrier management with the opportunity to improve their route network and it also provides an additional way for new firms to enter the business of scheduled air transportation. Any firm found to be fit, willing and able to provide air service by the Board may purchase route authority from an established carrier. In particular, this may be expected to help the supplemental air carriers who have for years sought to provide scheduled service. This provision will open markets for new firms and permit existing firms to rationalize their own systems. Since the transfer of operating authority will result in one carrier authorization being substituted for another, it will not increase the number of carriers authorized in any market unless an existing certificate holder is not using his route authority.

Eighth: Discretionary Mileage. To ensure a fully efficient air system some measure of flexibility and entry will be needed in the long term in addition to that provided by the removal of current certificate restrictions. The final provision of the Aviation Act of 1975 dealing with entry is aimed at providing this flexibility over the longer term.

Following the completion of the certificate restriction removal program, the Aviation Act of 1975 would allow each carrier to provide a limited amount of scheduled service in addition to those services specified in its operating certificate. Carriers could use this authority for a gradual expansion and rationalization of their route systems. The expansion process would be gradual since the total amount of new authority created each year would be limited to approximately five percent of system operations. Following a period of satisfactory service in markets entered under the discretionary mileage rule, the points served could be added automatically to the carrier's operating certificate without cumbersome procedures.

The entry provisions of the bill serve a number of important objectives:

A. Allow the development of low cost air service tailored to the needs of the market.

B. Eliminate waste and inefficiencies associated with past CAB certification practices.

C. Allow the threat of potential entry to police the pricing flexibility provisions of the Act.

D. Insure competitive market behavior under which an appropriate mix of price/service options will be offered to the flying public.

Taken together with the pricing flexibility provisions of the Act, the entry provisions would allow competitive forces in the airline industry to set fares, determine service patterns, and police market behavior. In short, the Aviation Act's entry and pricing provisions will substitute the market place for the Civil Aeronautics Board's judgment on crucial issues of air fares and service levels.

Anticompetitive Agreements

Antitrust Policy

A third broad area of present regulatory policy affected by the Aviation Act of 1975 is the Civil Aeronautics Board's grant of antitrust immunity to carrier agreements and to carrier mergers.

We have indicated in other parts of this testimony, the problem with such mergers and agreements, especially capacity agreements. The Aviation Act addresses the problem of antitrust immunity by providing new standards and procedures by which to judge such agreements and mergers. As discussed by the Secretary and the Assistant Attorney General previously, capacity limitation and pooling agreements would be barred.

For mergers, the Act provides that all restructurings be judged first by a standard similar to that used in the Clayton Act. Unlike the Clayton Act, however, there would be a weighing of the anticompetitive effects against the transportation convenience and needs of the communities. Specifically, the amendment provides that a restructuring may not be approved if it would result in a monopoly in any part of the United States or if its effect in any part of the country may be to substantially lessen competition or tend to create a monopoly, unless the Board finds the anticompetitive effects are outweighed by the transportation convenience and needs of the communities and such needs may not be met in a less anticompetitive manner. Both of these changes will do a great deal to bring airline merger and agreement policy in step with other areas.

Abandonments

Finally, the Aviation Act provides for a new abandonment procedure, and, more important, for a new subsidy system. The abandonment provision, in many ways, ratifies the present practice of the Board that it has exercised under its broad powers to control exit. The bill in essence provides that a carrier may exit an unprofitable point after sufficient notice to the community and time for adjustment . (Carriers can already exit from almost any unprofitable market so long as doing so does not entirely terminate their service to one of the points involved.) The main purpose of introducing this amendment was to ensure that the Board at some future date did not change its policy and force carriers to remain in unprofitable points. It was also introduced to encourage carriers to enter new markets,some of which might be marginal. If exit were restricted, carriers would hesitate to enter such markets for fear of being locked-in.

Even though the bill's abandonment provision does little to change the existing abandonment practice of the Board, it has created a degree of concern in some small towns and cities that carriers would take advantage of the law's new abandonment provisions and leave these communities without air service.

As detailed later, there is little basis for these concerns about our bill. For more than a decade, regulated airline service to small communities has continued to decline. Regulated carriers have dropped nearly a third of the points they once served.

The answer to this problem, however, is not to stop this abandonment. Carriers should not be forced to serve unprofitable markets. A party forced to provide service will seek to minimize the amount of service it provides, and losses in one community will have to be made up in excess profits in other communities. In addition, it is important to remember that as the regulated carriers left many small markets, their place was taken in most instances by the more efficient and unregulated commuter carriers. What was unprofitable for the regulated was profitable for the commuters, and the willing commuters often provided more frequent and generally better service than the certificated carriers.

The Administration has proposed as an amendment to the Aviation Act of 1975 a provision that clearly and simply guarantees air service to all those communities presently served by certificated carriers for up to ten years. The provision also calls for a study to examine the program created by our provision and the existing program. Since the subsidy provision was not submitted with the original bill, it would be helpful to outline the major features of the proposal.

1. <u>Guarantee:</u> The proposal guarantees essential air service to all those communities that receive such service from a certificated carrier on January 1, 1976.
2. <u>Effective date:</u> The amendment becomes effective immediately upon signing into law by the President. Within 180 days of enactment, the CAB must announce procedures for applying for subsidies and general definitions of what constitutes "essential service."
3. <u>Who may apply:</u> Any community now receiving service form a certificated carrier may apply, if it feels it is in danger of losing essential service without assistance. Final determination of a community's eligibility for subsidy will be made by the CAB.
4. <u>What airlines may be subsidized</u>: Any airline the CAB finds to be "fit, willing and able" to provide service, whether certified or not, may enter into agreements with the CAB. The Board may not give preference to carriers already serving the community in question. We would anticipate that most of the carriers that would receive subsidy would be commuters, but any carrier would be eligible.
5. <u>Contractual terms:</u> Agreements can be for up to three years and may be renewed up to 1985.

At least annually, the Civil Aeronautics Board will review average daily enplanements at subsidized points. At points where average daily enplanements are five passengers or less for the preceding 12 months, the community will, after one additional year, be required to pay half the costs of the subsidy. If local or state sources do not provide sufficient assurance that they will make up the difference, the CAB's subsidy obligation will cease.

Service may be discontinued prior to 1985 "only in exceptional circumstances if continued operation is not practical or the need for the service has declined to the point that continued operation is not in the public interest." Agreements must specify maximum rates, types of service, frequency, schedules, and equipment. *

6. Amount of subsidies: Subsidies will be determined by the Board on the basis of the costs of providing specific service to specific communities and on the basis of negotiations with interested carriers. The agreement price may not be increased for the benefit of an air carrier, unless cost increases are attributable to Federal Government action.

In summary, the amendment we have prepared will ensure continued air service to even our smallest communities.

* Agreements entered into pursuant to this provision must be in conformity with the Federal Property and Administrative Services Act of 1949. That Act provides that awards must be made to the person whose offer is "most advantageous to the Government, price and other factors considered." 41 U.S.C. 253.

I would like to turn now to the arguments which have been advanced by opponents of regulatory reform.

We have attempted to respond to these arguments on a number of occasions. The Department has undertaken a number of studies and research which is direcly responsive to these arguments. This research has been made a part of your hearing record. Despite the fact that we have carefully and,I feel,successfully responded to each of these arguments, they continue to be repeated in the same form and with all the original defects. I would hope that our testimony on this point would be reviewed carefully. We have a duty to respond to all legitimate concern regarding the care for the legislation and the effects of the legislation. We feel strongly that we have effectively and successfully responded to the counter-arguments. In Secretary Coleman's extended testimony he dealt with these arguments in great detail. I would like to review that evidence with you.

THE ARGUMENTS USED TO OPPOSE REGULATORY REFORM

Service to Small Communities

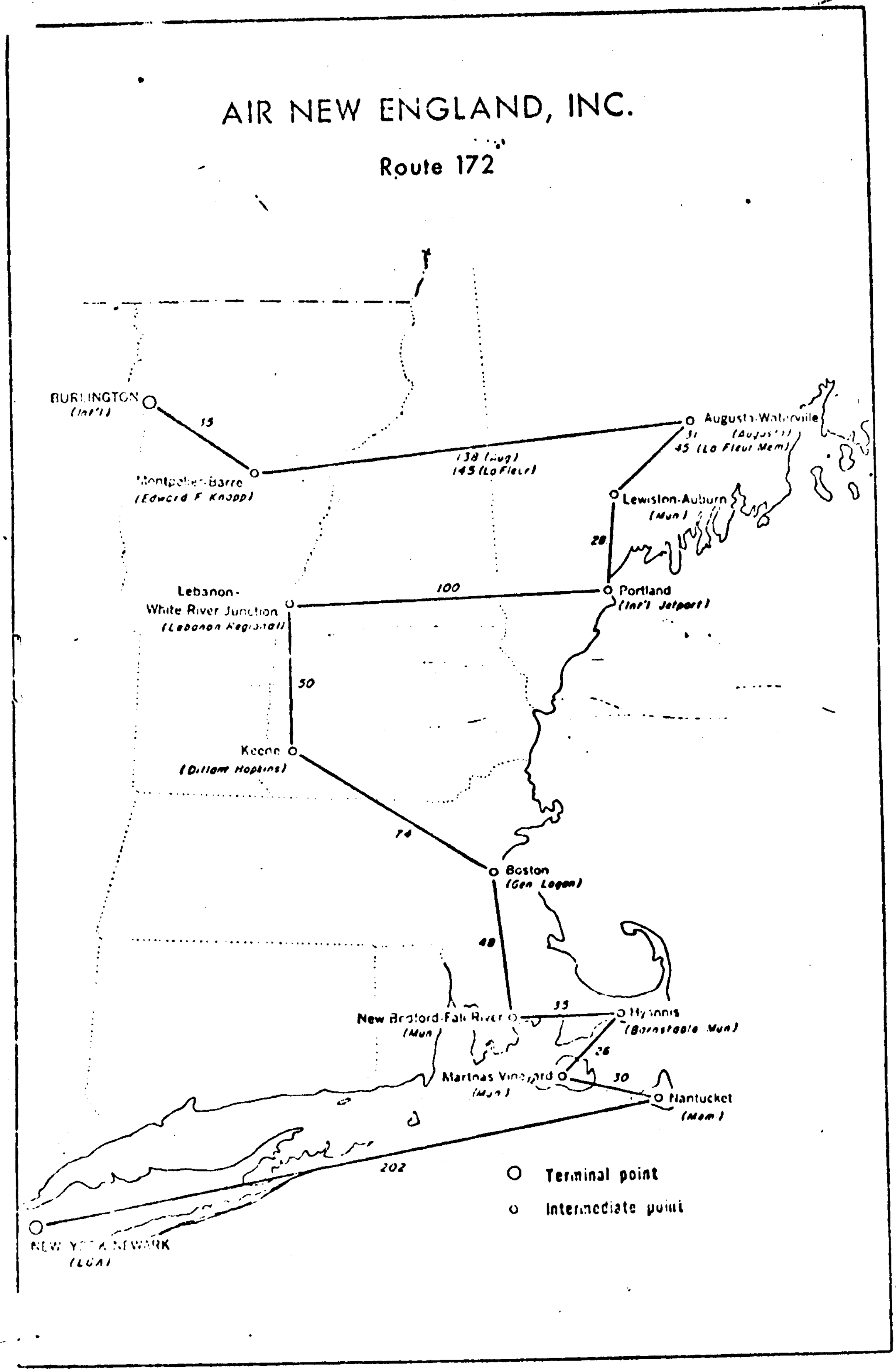
There is a myth that less regulation would result in widespread loss of service -- especially to small communities. Although this myth is widespread, and fostered by the aviation industry, it is simply not true. Rather, the present system of economic regulation has permitted the withdrawal of certificated service to many small communities. In contrast the Aviation Act will be most beneficial to small communities. This section will outline the myth, the true situation, and what the proposed Aviation Act would do for service to small communities. The Department has an extensive report on this issue, and this testimony only summarizes that report.

Route Certification and Restriction

The Civil Aeronautics Board is prohibited by law from controlling either equipment or schedules. The obligations for service contained in the present statute are minimal and, as a result of this factor and the Board's statutory inability to control equipment and scheduling, the Board seldom requires that any particular route be flown. In other words, the Board requires that a community receive "some" service, not that it receive 10 flights a day, or that it be connected to three other communities.

The service may be non-stop, multiple stop, or connecting service. Service between any two points on a carrier's system may even be so poor that connecting schedules are not even published in the Official Airline Guide. In addition, the Board has been quite liberal in allowing carriers to drop points entirely. The result is that all carriers have a large amount of discretion in choosing the markets they wish to enter and the level of service they wish to provide in each market they serve. They do not have to use all of their route authority and most serve only a tiny fraction of the authority theoretically available to them. This implies that within constraints imposed by the Board, the level of service provided by the airline industry and the markets served are established by market demand rather than by dictates issued by the Board. Service is not being provided now because it is a condition of route certification. Carriers will continue to serve profitable routes regardless of whether the regulatory system is changed. There will be little or no reduction of service at any community where air service is profitable which is almost all communities. Indeed, as we will demonstrate, service will be greatly improved and the proposed bill contains a guarantee that no community presently served by a certificated carrier will lose air service for 10 years.

Figure 1



Air New England
Route 172

The easiest way to illustrate the point that the present system provides little help to small communities is to actually look at one certificate. One of the simplest route certificates is that of Air New England, which authorizes Air New England to serve the 13 points shown in Figure 1. The privilege of serving those 13 points carries with it an obligation to provide some minimal level of service to each point. This has generally been interpreted by the Board to mean that each point must receive one or two daily flights (weekends excluded). So long as it provides one or two flights per day to each point, Air New England may provide service among any city-pairs or to any series of points named on its certificate unless explicitly prohibited by restrictions in the certificate. Air New England has two restrictions: it may not provide non-stop service in the Burlington-New York market, and it may not provide non-stop or single-stop service in the Boston-New York market.

Air New England might serve its cities by establishing a hub at, Keene, New Hampshire for example, and serve every other city from there. This "hub and spoke" type arrangement would again allow Air New England to serve each point with a minimum of 12 flight segments. Alternatively, Air New England could provide non-stop service between all of the 76 city-pairs it is authorized to serve.[1/]

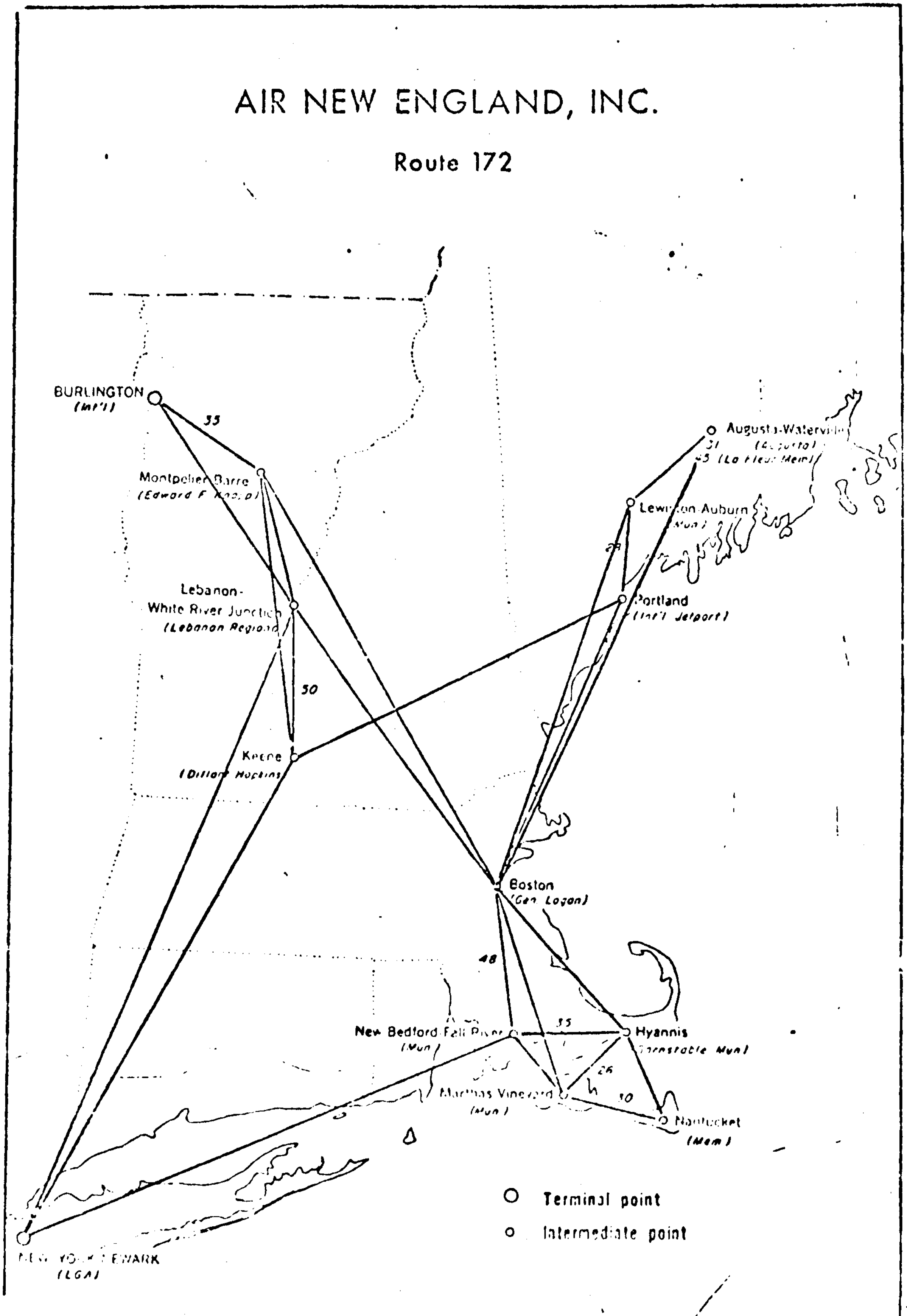
In August 1975, Air New England actually served the 24 flight segments shown in Figure 2. It did not serve 52 potential non-stop routes which they were free to serve without restriction.

Several features of the route certificate, the obligations imposed, and the resulting service pattern should be noted.

First, Air New England has a great deal of latitude in choosing the markets it wishes to serve. It may add or drop city-pair markets without Board approval. Since any city-pair market can be dropped by Air New England, the only guarantee of service for the points on Air New England's system is that one or two flights per day will continue to be provided. The flights may be to or from any other point served by Air New England, they may arrive at any hour the carrier chooses and with any equipment the carrier chooses. Thus, the obligation imposed on the carrier is minimal, as is the value of the "guarantee" to the community being served.

1/ Since Air New England serves 13 points, it could provide service, in the absence of restrictions, to 78 unduplicated city-pairs. The general formula is $\frac{n(n-1)}{2}$, where n represents the number of points. Since two markets are restricted, Air New England can therefore provide service in 76 different city-pair markets.

Figure 2



Air New England
Route 172

Second, Air New England has a great deal of unused route authority. It uses only one-third of its potential non-stop authority.

Third, the restrictions applied to Air New England serve to prevent competition rather than to guarantee service. For example, consider the first of Air New England's restrictions, that it must make at least two stops in providing service between Boston and New York. Six other carriers (American, Delta, Eastern, National, TWA, and United) now provide approximately 50 daily non-stop trips in each direction between Boston and New York. In the face of this competition, Air New England is not likely to become a viable competitor with two-stop service and simply does not attempt to participate actively in the market. Thus, the restriction does little to aid the four points (New Bedford, Hyannis, Martha's Vineyard, and Nantucket) which might benefit by forcing Boston-New York traffic to stop through those points. Furthermore, even if the restriction were intended to force traffic through small points, the restriction would help only two of the four points. These would ordinarily be the two largest points. The two smallest points presumably most in need of protection would receive little or none. Air New England's other restriction, that non-stop service may not be offered in the Burlington-New York market, has the identical characteristics of limiting competition without guaranteeing or protecting service.

The restrictions imposed by the Board on carriers are basically aimed at keeping competitors out of the markets served by other airlines rather than compelling service that would not otherwise be provided. North Central Airlines offers an excellent example. North Central serves 39 points where it is the only certificated air carrier. In each of those 39 monopoly points it faces no route restriction of any kind. It can provide any type of service between each of those monopoly points and any other point on its system. And it can provide any level of service to each of those points it chooses. The only restriction is that one or two daily flights must be scheduled into each point. In contrast, North Central serves 28 points which are also served by other airlines. At each of these points where North Central is not a monopolist, it faces restrictions on the type of service it can provide. In general, the more potential competitors North Central faces at a point and the larger the point is in terms of traffic generated, the more restrictions North Central has in its certificate.

This is the nature of the present system of restrictions imposed by the Board -- they restrict competition, keep airlines out of competitors' markets, and tell the airline what it may not do. The restrictions imposed by the Board do not compel service in particular markets. The net result is that the Board is permissive in letting a carrier provide whatever service it desires in the markets he is authorized to serve. The Board is restrictive in keeping carriers out of the markets of competitors. By removing those restrictions, the proposed legislation would result in more service -- not less air service.

Cross-Subsidy

The argument is made by some that regulatory reform would disrupt service to small towns by eliminating cross-subsidies. The contention is that trunk airlines (those airlines not eligible for direct Federal subsidy) serve unprofitable markets now because they are able to support such service with profits from other markets. The increased competition fostered by regulatory reform would eliminate the excess profits used to cross-subsidize service in unprofitable, low density markets and some communities would lose trunk airline service as a result.

To be persuasive this argument requires evidence that trunk airlines both lose money on some routes and voluntarily elect to subsidize this unprofitable service out of excess profits earned elsewhere. As seen earlier, airlines have considerable latitude in restricting or eliminating service in unprofitable markets. And, of course, there is no regulatory requirement that they use excess profits to subsidize unprofitable service and certainly no incentive to do so. Thus, it would be surprising to find widespread prevalence of cross-subsidized trunk line service.

For trunk services, the Board has not for years encouraged cross-subsidies and has attempted to eliminate them where they do exist. There is no reason to believe that substantial cross-subsidies exist, first, because airlines are generally free to discontinue unprofitable services, and second, because the airlines have never been able to prove such cross-subsidies.

In response to a request from the Senate Judiciary Subcommittee on Administrative Practice and Procedure, United Airlines provided information on alleged cross-subsidy within its system. When costs and revenues were first allocated, half of United's 327 city-pairs were labeled as unprofitable and a loss of $142 million in serving these city-pairs was estimated. However, only 58 of the city-pairs were unprofitable in the sense that the revenue generated failed to cover incremental costs. The remaining city-pairs, while not covering fully allocated costs, did have revenues which more than covered incremental costs and United had no intention of dropping them. What of the remaining 58 city-pairs? Four of the 58 were flown for the purpose of repositioning aircraft, seventeen were flown because of their traffic generating ability, eight were shorter than 60 miles in length (and in no need of trunk service), and the remaining 29 flight segments were the only ones which might be detrimentally affected by even total deregulation.

As the Senate Subcommittee's report pointed out, these 29 flight segments accounted for only one-half of one percent of United's revenue passenger miles and the annual loss associated with those routes was only $5.5 million. This estimate is, incidentally, equal to only three-tenths of one percent of United's system-wide revenues, and equal to only three percent of United's overall profits for 1974. Thus, the amount of cross-subsidy in United's system is quite small. We agree with the belief the Senate Subcommittee, and others that this is typical of the industry in general.

Abandonment

What is the situation at small communities? Trunk airlines operate jet airplanes with ninety or more seats. The smallest aircraft operated by local service carriers usually have more than fifty seats. Many of the local service carriers are converting to aircraft with ninety or more seats. Realizing that it is uneconomic for a large aircraft to stop to pick up one or two passengers, the CAB has generally permitted carriers, especially unsubsidized carriers, to abandon service to most unprofitable cities -- those where only few passengers board. As a result, many small towns have lost certificated air service. Since 1962, more than 170 points have lost such service and certificated carriers now serve only about 400 communities in the 48 States.

What caused this decline in service and loss of service at many points? A variety of factors are involved, including the development of the Interstate Highway System, which made regional airports more attractive and eliminated the need for many nearby airports. But other important factors are associated with the present system of economic regulation and the present subsidy program. The Board's route strengthening program was designed to let local service carriers participate in larger markets. The goal was to allow such carriers to earn profits with which to cross-subsidize other routes. The Board's 1972 study of air service to small communities could find no evidence of cross-subsidies resulting from the route strengthening program. However, it did transform the local service carriers into miniature trunkline carriers -- shifting their emphasis away from service to small towns towards service on major routes with larger aircraft.

A second factor in the decline of service to small communities is the present subsidy system which has at times provided carriers incentives to procure ever-larger aircraft.* As local service carriers have hastened to convert to all jet fleets, service to small communities has become ever less attractive to them. Thus, the present regulatory system has not protected air service to small communities. Indeed, if anything, it has hastened abandonments of service at many points.

The withdrawal of certificated service from small points is continuing rapidly and, may be increasing in tempo. Between 1970 and 1975 the number of communities with populations under 100,000 receiving certificated service declined by about 14 percent. Weekly flight frequencies dropped by about 25 percent. At the start of 1975, certificated carriers served 43 points in the Continental 48 States which boarded 10 or fewer passengers per day. In the fifteen months since that time, certificated service has been discontinued at one-third of those points, and abandonment or suspension proceedings

* Eads, The Local Service Airline Experiment, pp. 134-135.

are now under way for several other points. As local service carriers continue to increase the proportion of jet aircraft in their fleets, service to small communities will become increasingly expensive, along with subsidy needs. As a result, the pressures to abandon the smallest points will continue to increase.

Growth of Commuter Service

Fortunately, at a time when certificated service was declining in many areas, many small communities are getting better air service than ever before. They receive service from unregulated commuter air carriers. These carriers, flying small aircraft and exempt from Board regulation, are able to enter or leave markets as they choose and set their own prices free of Board interference. Although still tiny in comparison with the certificated carriers, commuter carriers have grown far faster than certificated carriers during recent years. In many ways they offer service superior to that of the regulated carriers at small points. They tend to offer greater flight frequency and lower fares over short distances. The larger commuters have typically been in the industry between 10 and 20 years, offer excellent reliability, and are far less likely to abandon small points than are certificated carriers, even though they are under no theoretical obligation to continue service at a small point. Commuter air carriers now provide scheduled and unsubsidized service to 230 communities under 100,000 population. At 150 of these communities, commuter carriers provide the only scheduled air service. These cities -- tending to be the smallest receiving scheduled air service -- receive service not because of economic regulation. Rather, the smallest communities receive service only because of an exemption from economic regulation. If these smallest of cities were to depend solely upon certificated air carriers for service, many would be receiving no service at all.

Small communities will benefit from enactment of the proposed legislation. As air travel throughout the nation increases, so will the "feeder" traffic generated by small communities. The result will be a "trickle down" or "boot strap" effect-- more people will travel from small points to use the more heavily traveled parts of the system, resulting in greater flight frequencies, resulting in still more traffic being generated. The liberalization in the size-of-aircraft restriction applicable to commuter airlines will help all but the very smallest of our communities.

Subsidized Service

The present subsidy program was intended to guarantee service to small isolated communities. The widespread abandonment of service by certificated carriers attests that it has not served this purpose. The unsubsidized commuter airlines are the bulwark of service to small communities. And much of the current subsidy pays for services that the market would be willing to provide at no cost to the government.

The Aviation Act makes an important change in the current subsidy system. For those communities receiving certificated service, the present subsidy program is retained, although it has not had a noticeable effect in encouraging carriers to continue service to the smallest of communities. But beyond this, the legislation contains a meaningful guarantee of continued service to small communities. Every community now receiving service from regulated carriers will be guaranteed a continuation of scheduled air service for ten years. In the event that a regulated carrier abandons a point and that point would be left with no scheduled air service, the Board is empowered and directed to contract with a commuter air carrier to provide continued air service to that community. This guarantee of continued service at small points is immensely superior to the prospects faced by such communities today. If certificated carriers abandon today there is no guarantee of continued service.

In summary, air service to small communities is not endangered by this legislation. Indeed, the decline of air service to small communities under the present regulatory system and the fact that the present regulatory system has often hastened that decline is one of the reasons why this legislation is necessary. The proposed legislation will enhance the situation of small communities both by improving the health of the aviation system in general and by providing a guarantee of continued service to the smallest of points for 10 years.

Market Chaos

The myth that regulatory reform will lead to "market chaos" consists of a series of allegations which seem intended to frighten or confuse. A picture is painted of an industry responding to increased management discretion by rushing around in blind confusion, all concentrating on a few markets, abandoning scores of others, and generally destroying each other. It is alleged that passengers would be unable to make reservations; nobody would know from day to day who flies which routes and at what fares; airlines would not transfer baggage or make interline reservations; airport operators would not know who will use their facilities; long-range planning would be impossible; and chaos would result. The market would not function.

Why the airline industry is so different from other industries that are not regulated and are not bent on self-destruction is not clear, but the argument is made nevertheless. There is no justification for such an argument. But this chaos argument is often made as a defense or excuse for continued anticompetitive practices. For example, in the historic antitrust case against electrical equipment manufacturers, the claim was made that without price fixing and market sharing agreements among suppliers, the markets for turbines, generators and similar equipment would become chaotic. Prices would fluctuate excessively and electrical utilities would be deprived of stable sources of supply. The court was unconvinced.

Most markets are unregulated and these markets function in a generally efficient way without chaos. Firms make long-run commitments and customers are able to secure services. It is in the suppliers' interest to give orderly and dependable service. The unregulated portions of the airline industry operate in this fashion. Commuter airlines are not subject to economic regulation but they make reservations, adhere to schedules, and make long-run plans. Their fares are known, they transfer baggage, and in every respect they render service the public wants and is willing to pay for. Service in intrastate markets is also available for comparison. There is no chaos there.

The argument that there will be a headlong rush to provide service only on well-traveled routes is clearly refuted by the service rendered by commuter airlines and by the experience in the intrastate markets. Unregulated and unsubsidized commuter airlines have actively moved into low density markets. They have done so because people are willing to pay for airline service in these markets, not because of regulatory requirements. There are now some 200 commuter airlines carrying some 7 million passengers annually, mostly in low density markets. Their air fares, moreover, are comparable to certificated carriers' fares on comparable routes. Commuter traffic is the fastest growing segment of the airline industry.

Where price and entry regulation has been relaxed in the California and Texas intrastate markets, service has not bunched into a few major routes. In fact, in Texas, service to relatively small communities such as Harlingen has improved markedly. And intrastate carriers have taken the lead in dispersing traffic out of the major hub airports. Service from satellite airports benefits passengers by reducing their total door to door travel time. In California, for example, instead of service being concentrated at the major San Francisco and Los Angeles airports, it has been dispersed to twelve airport pairs.

A final refutation of the chaos myth is that airlines today use far less of their operating authority then they could. This proves that airline managements are fully capable of assessing markets. They would not respond to a lessening of economic controls by rushing about blindly to the detriment of all. To put this in perspective, carriers now use less than 20 percent of their certificate authority and often do not use all of their certificate authority even in major markets.* So considerable discretion and flexibility does exist in the system today. Not enough, to be sure, and not necessarily in the right places, but a significant amount. And this has not led to chaos.

* See Attached Table.

TOP-RANKED MARKETS IN WHICH THERE IS UNUSED NONSTOP AUTHORITY

Market	Rank 1/	Annual O&D Passengers 1/
New York-Washington	3	1,638,310
Chicago-Detroit	13	590,490
Boston-Washington	15	579,360
Buffalo-New York	19	526,670
Boston-Philadelphia	27	409,360
New York-Rochester	28	408,030
Los Angeles-Seattle	31	376,670
Miami-Philadelphia	57	260,600
Boston-Los Angeles	62	252,900
New Orleans-New York	63	252,860
Boston-Miami	69	238,970
Detroit-Los Angeles	71	237,600
Miami-Washington	72	236,680

1/ From CAB O&D Survey, Table 6 12 months ended March 31, 1975.

Predatory Practices and Cut-Throat Competition

Some opponents of regulatory reform contend that the Act will lead to predatory price cutting as firms try to drive others out of the market. This will not occur under the Aviation Act and in fact the bill will reduce the prospect of predatory actions.

The price flexibility provisions of the bill will change the form of competition rather than increase its intensity. Airlines now rely principally on service competition to attract passengers from competitors. The Aviation Act will allow them to compete on the basis of both price and service. Thus price flexibility will change the emphasis of competitive efforts but there is no reason to believe it will lead to ruinous conditions in the industry, i. e., a condition under which rates are chronically below fully allocated costs.

Equally important, the entry provisions of the bill greatly reduce the prospects for predatory conduct. Since predatory competition entails certain short-term losses, a rational firm would engage in such conduct only where there existed a strong prospect of obtaining monopoly profits either by driving other firms from the market or by disciplining the market. Two conditions are essential for predatory pricing.* One, the predator firm must have superior resources which gives it greater staying power to achieve the purpose of driving the rivals out of the market; and two, there must be high barriers to entry to enable the predator firm to recoup its losses. In other words, the prospect of eventually realizing monopoly

* See extended discussion: Areeda and Turner, "Predatory Pricing and Related Practices Under Section 2 of the Sherman Act, 88 Harv. L. Rev. 697 (1975).

profits from the predatory conduct must be high. Where entry or re-entry can occur relatively easily whenever prices return to levels at or above cost, the incentive to engage in such behavior is eliminated. By reducing the barriers to entry, the Aviation Act will also reduce the prospect of successful predation. As discussed elsewhere in this testimony, there are no effective entry barriers other than regulatory barriers in the airline industry.

Finally, actual experience in markets where price competition and entry have been allowed confirms these conclusions. The experience of the California and Texas intrastate carriers certainly suggest that price competition in the airline industry does not have destructive results.

The underlying economic characteristics of the industry along with the reduction in the barriers to entry resulting from the Aviation Act indicates that predatory pricing does not pose a serious problem in the airline industry. In addition, it should be noted that the Aviation Act itself would prohibit rates below variable cost and, of course, remedies under the antitrust statutes or section 411 of the Federal Aviation Act which prohibits unfair competition would continue to apply.

Regulatory Reform Will Lead to Monopoly

It is sometimes argued that regulatory reform will eventually lead to monopoly. This would only happen if there were significant economies of scale in the industry. Such cost conditions do not exist in the airline industry. It is sometimes claimed that scale economies are present in the industry because large aircraft have lower costs per seat mile than small aircraft. But both small and large airline firms are able to purchase large aircraft. They will do so to take advantage of aircraft-related scale economies in markets where large aircraft are justified.

The issue of scale economies in the airline industry has been extensively researched and practical experience confirms the research findings that small firms can operate as efficiently as large ones. The report by the Subcommittee on Administrative Practice and Procedure (p. 38) notes, for example, that a thorough search of the literature by Professor Peltzman reveals unanimity of view on this point. The intrastate experience of small airlines like PSA, Air California, and Southwest competing highly successfully with major trunk carriers is also convincing.

Moreover, for industry concentration to lead to monopoly abuses, the surviving firms would have to be able to bar new entrants. Otherwise competing firms would reenter markets when the existing firms tried to raise prices. But other than regulatory barriers, there are no effective entry barriers in this industry. The relevant technology is generally available; aircraft can be acquired. Airport facilities can be leased. The necessary management structure can be created. All this may not be easy, but it can be done by corporations where there are prospects of future long-term profitability. It is important to recognize that under competitive conditions there may be only a few competitors on some low and medium density routes. But they will not be able to exploit their monopoly power because the potential of entry will discipline their market actions. This is the reason that the bill provides for both price and entry flexibility. The ATA wishes to continue severe entry restrictions while allowing price flexibility. Their intent is obvious. Such a policy would ensure that airline monopoly power on low and medium density routes will not be restrained by the threat of competition from new entrants.

In short, this is not an industry which is inherently monopolistic and the fear of monopoly emerging is unfounded. Ironically, the present regulatory system is the only "hope" for monopoly. As Professor Caves said at a recent seminar on air transportation:*

"The preclusion of entry by new airlines has greatly reduced competitive pressure on the certificated carriers for efficiency and performance, and the preclusion of entry into individual city-pair markets -- whether by newcomers or airlines established elsewhere -- has removed the one ultimately effective curb on the tendency to high concentration in the individual city-pair market. These entry restrictions are all the more

* Conference on Regulatory Reform and the Aviation Act of 1975, Transportation Center, Northwestern University, Feb. 29-March 1, 1976.

damaging to the industry in the long run because airlines sometimes disappear from natural causes, and indeed the mortality rate is increased by the rigidities of the certificated route structures that consign some carriers to unprofitable route structures and promote 'failing-firm' mergers. Therefore the regulated industry has a long-run tendency toward fewer and fewer airlines."

Airlines Are Like Public Utilities

Opponents of regulatory reform have argued that the present restrictive regulatory system is required by the public utility aspects of the airline industry.

This claim has two possible facets. One is that airlines, like utilities, are natural monopolies and thus must be regulated to prevent monopoly abuses. The natural monopoly argument, however, requires that there be long-run economies of scale among airline firms. Only if unit costs decrease with firm size can a few large firms drive out the competition in a freely competitive market and establish monopoly power. Where there are substantial economies of scale, economic regulation is often felt to be in the public interest.

But as indicated above, airlines are not subject to increasing returns to scale. There is widespread agreement among scholars of airline economics that small firms can be as efficient as large ones so that numerous firms would co-exist in a competitive industry.

These findings of academic scholars are reinforced by actual experience in many markets. Small and large firms compete head-to-head in many markets, with large firms having no particular cost or marketing advantage. There is simply no substance to the argument that airlines are natural monopolies and thus should be regulated like public utilities.

It is also alleged that the current system of regulation is required because the industry, like a public utility, has an obligation to provide service. Public utilities are regulated because they have a natural monopoly. Because of this monopoly they are required to provide service to all customers and prices are regulated. The obligation to serve is imposed because the consumer has no alternative to turn to, and price regulation is required because otherwise customers would be exploited by the monopoly. In other words, utilities are not regulated because they are required to serve; they are regulated and required to serve because they are monopolies. This is not the airline situation because airlines are not natural monopolies.

The facts regarding the airline's obligation to serve also contradict the "public utility" argument. As indicated earlier, airlines have great discretion over the type of service they choose to provide to a given point. They also have great latitude in deciding whether to serve points on their system at all. Of the 543 points served in 1963 by certificated carriers, only 394 now receive certificated service. Most of the points abandoned by certificated carriers are now served by commuter airlines that are unregulated by the CAB. Thus, it is clear that the "obligation to serve" is not what ensures continued service.

Airlines Are Unique ?

Some have argued that the airline industry is somehow a unique or different industry; that other industries can exist without regulation, but not the airline industry. Sometimes this is stated in terms of the complexity of the airline system, and the specific examples given are the need to interline and to maintain elaborate reservation and baggage systems. Also pointed to is the inability to inventory a finished product. Once the plane departs, all the empty seat capacity is gone. Other industries can inventory in slack times, and then sell their inventory and make their profits in better times. The airline industry cannot "inventory." And the airline industry is subject to large changes in demand, and to the changing wants and pocket books of tourists.

The airline industry is not unique. It is a service industry, and has the same problems and opportunities as many other service industries. The airline industry's unique characteristic among service industries (excluding other transportation modes) is that it is regulated.

As an example, the hotel/motel industry is much like the airline industry. It is large, nationwide, has the same "inventory" problem, it has a complex reservation system and is subject to the whims of tourists. Obviously, there are many differences, but the similarities are there too.

One of the differences is that the hotel/motel business is not regulated. As a result, one of these service industries is constantly before the Federal Government for one reason or another, while the other industry devotes its skills and energies to business management; one of the industries offers the consumer a wide variety of product offerings at a wide variety of prices, while the other industry does not.

The essential point is: The special circumstances of the airline industry are the result of regulation, not of any inherently unique features of the business.

How Can Fares Drop If Costs Don't Drop?

The Air Transport Association has argued that it is illusory to think that fares would be lower under regulatory reform. The argument is that fares cannot drop if the prices of fuel, labor, aircraft and other supplies purchased by the industry do not drop.

Fares would decrease with a lessening of economic controls not because the costs of inputs would decrease but because fewer inputs would be used per passenger. With increased emphasis on price competition costly service competition would decrease. Air carrier productivity will therefore increase, and this will provide the basis for fare decreases.

Of course, fares would not come down in every market. Also, in an economic environment characterized by continuing inflation, costs will tend to rise. But the important point is that these costs will increase less in a more competitive environment than they would have increased if the present regulatory system were continued. As carriers achieve efficiencies, the pricing and entry/exit provisions of the Act will assure that any cost savings resulting from those efficiencies we passed on to travelers and shippers. Average prices will be lower, as a result, than they would be under a continuation of the present regulatory system.

Carriers will be less likely to compete for customers by over-scheduling flights. As a result planes would fly more fully loaded, and the costs per passenger would drop. Wasteful route restrictions will also be eliminated, and carriers will be allowed gradually to rationalize their systems through the discretionary mileage and the certificate transfer provisions of the Act. This will further increase the efficient utilization of resources and reduce per passenger costs even though the prices of inputs stay the same or rise gradually.

The experience in the California and Texas intrastate markets shows that the reduction of economic controls can, under certain market conditions, lead to substantially lower fares. The intrastate carriers have been faced with the same rising fuel, equipment, construction and labor costs as interstate carriers, yet their fares are considerably lower for comparable routes.

SAFETY

Some carriers have argued that increased competition would lead to lower profits, which would lead airlines to cut costs and the amount they spend for safety. Safety is a primary concern for all, and the Aviation Act of 1975 will not in any way endanger safety. The basic assurance that airlines will fly safely is not provided by economic regulation, but rather by strict enforcement of Federal safety regulations. Congress has recognized this separation between safety and economic matters by giving the economic regulation to the CAB and the safety regulation to the Department of Transportation and the Federal Aviation Administration. The Congress has also established the National Transportation Safety Board as one independent agency for transportation safety monitoring and fact-finding purposes. The Department and the Administration have repeatedly stated that they will not permit any diminution in the strict enforcement of the safety regulations. The Aviation Act only affects economic regulation.

The Aviation Act of 1975 continues in its declaration of policy the mandate that the Board consider "the importance of the highest degree of safety in air commerce" as being in the public interest and in accordance with the public convenience and necessity.

The Federal Aviation Administration is prepared to offer more detailed explanation of the points in this section.

Airline Financing

Some have argued airlines will not be able to obtain needed financing under a new system of regulation. The argument takes two forms. Some claim airlines must always be strictly regulated or they will not be able to attract capital. Others argue that the current financial difficulties of certain airlines coupled with the large future capital requirements of the industry are so serious as to preclude regulatory modernization now. Both arguments are faulty.

It is clear that, under the present regulatory system, insulation of the industry from the functioning of competitive market forces has not resulted in high industry profitability. In fact, returns in the airline industry have been low, and there are questions today about the industry's basic financial health. Effective public service can only be provided by an industry that is financially strong. The industry must be able to compete for funds in the capital markets in order to replace aging equipment and to satisfy future growth requirements.

Although air carriers have been able to attract needed capital in the past, the performance of the present regulatory system does not provide confidence in the future. Regulation has contributed to a cyclical pattern of carrier earnings. Only twice in the past 18 years has the industry's return on investment exceeded 10 percent. The average return on investment in this period has been less than 6 percent. While industry revenues grew in this period from \$2.3 billion to more than \$15 billion annually, this growth was not matched by growth in profitability.

Each successive cyclical downturn in the last ten years has left several carriers weaker. The industry and its regulator can no longer count on long-term growth rates high enough to shield each and every carrier from temporary downturns in traffic. The prospects are for lower rates of growth and unfortunately, under the current regulatory system, for continued low profits. If something is not done to correct the situation, we may not be as fortunate in the next cyclical downturn as we were in this one.

Public statements by lenders indicate their apprehension about financial prospects for the airline industry. Certainly the present system of airline regulation is not creating lender or investor confidence.

The industry is now emerging from the low part of a business cycle. The current difficulties faced by some air carriers in obtaining financing must primarily be attributed to the industry's cyclical history of generally poor financial performance. The poor profitability of airlines gives investors and lenders little encouragement that weaker carriers will be able to achieve reasonable and consistent average earnings in the future. This poor past performance took place during a period of rigid government regulation.

The roller coaster cycle of airline earnings and investment is costly and leads to inefficiencies. The need is to reform regulation in such a way as to result in more earnings stability and encourage more even investment patterns. The problem with an industry which is as dynamic and as naturally competitive as the airline industry is that, under present regulation, there is not any way to assure a stable, guaranteed return and a consistent pattern of capital investment while at the same time encouraging efficient, reasonably priced air service properly adapted to market needs.

As has been pointed out before, the existing airline regulatory system does not work well. This is particularly so in an inflationary, mature-growth environment because managers do not have enough flexibility in pricing to adjust to cost changes, test their markets, or price in response to differing conditions in different markets. Nor has the regulatory system shown itself able to cope adequately with a dynamic industry whose fortunes follow the economy.

Although immediate airline expansion needs are modest on average, the industry will need significant numbers of new aircraft in the next ten years. 1/ In addition to replacement of older, noisier and less

1/ In the next three years, we estimate that the investment requirements for the airline industry will average about $1.5 billion annually, primarily to replace older, less economical aircraft. The need for industry-wide financing through earnings and external capital sources will increase after 1978, when continued traffic growth will create a need for major additions to airline capacity. Estimated annual industry capital investment in 1979 and beyond will be over $3.5 billion.

efficient equipment, the industry needs to secure a new generation of quieter,more efficient aircraft, and to acquire additional capacity to satisfy normal growth in demand for air travel.

The phased price, entry and exit provisions of the Aviation Act, including the flexibility to sell and exchange routes, will allow air carrier managements to improve their financial position. This will enable them to attract the capital required in the next decade. The regulatory reform provided in this bill is necessary if the industry is to be fully responsive to the public demand for its services during this period.

The bill is phased to avoid near-term disruptions of airline finances. Pricing flexibility is gradually phased in over three years. The liberalized entry provisions do not become fully effective until the sixth year. During the transition period, the industry will be profitable and gains in productivity from the elimination of regulatory inefficiencies should be passed on to the public in the form of fares lower than they would otherwise be.

This is an ideal time to initiate regulatory reform. Under the phased program of the Aviation Act of 1975, the transition to a more competitive and less regulated industry will occur during a period in the airline financial cycle when excess capacity does not exist. Corporations and managements will be able to accommodate to change in an orderly manner without financial turbulence or disruption in service. The industry will be buoyed by rising demand and tight industry capacity. Carriers will be able to adapt their route structures to become more efficient, and price to reflect cost and demand conditions.

In the transition period and beyond, managements who are able to convince investors and lenders of their efficiency and ability to earn market-required financial returns will be able to secure equity and debt financing, and their firms should prosper and expand. Less efficient managements, unable to earn adequate returns, will not be able to attract capital. This is as it should be. Corporations in this position will have strong incentives to acquire more efficient managements, or gradually to shrink their operations by withdrawing from unprofitable routes and by selling assets. The working of competition in the marketplace will ensure that the benefit of improved efficiency in air transportation is passed on to consumers through the medium of lower rates.

Carrier managements will be encouraged not to expand excessively and not to compete for market share if by so doing their corporations become insufficiently profitable to obtain needed financing. By the same token, the public will be protected by ensuring that competition will prevent excess profits.

This result does not equate to instability and chaos. It does represent a requirement that more reliance be placed on the discipline of the marketplace in regulating efficiency and productivity. Under a less-regulated environment, financial requirements will undoubtedly be as stringent for airlines as for other industries. The high forecast long-term capital requirements and heavy competition for funds will force air carriers to be profitable if they are to be able to grow in meeting the public demand for air service. There is no substitute for earnings if the industry is to attract capital. This requires that air carriers be able to earn financial returns related to the risk associated in creditors' and investors' minds with the industry. The market will set the required rate of return and air carriers will be able to attract needed capital.

AIRPORT FINANCING

Air transportation regulatory reform would not result in erratic air service nor would it undermine the stability of airport/airline financial arrangements which are needed to finance airport facilities.

An argument has been raised that enactment of the Aviation Act would make airport planning and financing difficult. This assertion is based on the assumption that major dislocations and disruptions would accompany implementation of the Aviation Act. This assumption is inconsistent with the phasing provision of the Act, does not take into account the improved health of the industry which will result from the Act and ignores the prospect of increased traffic.

In the end, it is the traffic generated by the carriers serving a community that is the basic guarantor of airport revenues. Airports are generally financed by bonds which are guaranteed by the revenues that the airport generates. The Aviation Act, by promoting greater productivity and efficiency in the air transportation system, and by passing on savings from greater productivity in the form of lower prices, will promote greater travel and growth in the system. This will increase the traffic base which supports airport financing.

The air service will be increased throughout the system under the Aviation Act of 1975 -- from large metropolitan areas to small communities. Service to the public will be greater at large, medium and small hub points as well as non-hub airports. Thus all categories of airports will potentially be able to depend on a large traffic base.

Where congestion and capacity limits exist at some large hub airports, growth can be handled at less-congested or under-utilized facilities, or by means of new traffic connecting complexes. This will improve the financial viability of satellite airports.

Today, airports are generally financed through revenue bonds. These bonds are purchased on the strength of long-term (15-30 years) obligations of the carriers serving an airport. Airline contracts generally contain limited termination provisions. An airline obligation to underwrite an airport bond is only as strong as the basic financial strength of the carrier. A guarantee from a weak carrier even under today's system may be no guarantee at all. Moreover, today if service becomes uneconomical carriers will withdraw despite the guarantee.

Nothing in the Act limits the right of airport owners to require a carrier to assume a long-term financial obligation before operating out of an airport. Airports will continue to have the power to protect their financial arrangements. Entry and exit, in this respect, will not be "free" from the point of view of an airline management. Just as corporations assume long-term aircraft leases and building leases, so must they assume responsibility for long-term airport facilities leases. The Act does not change this. But by creating a healthier, more financially stable airline industry, the Act will strengthen the ability of carriers to service their airport obligations. The airport obligations themselves will remain as an important stabilizing influence on air service, in that carriers will tend to plan and operate for the long term, thus allowing airport managers to plan and finance for the long term.

The Federal Government itself must plan airport and airway facilities for the long-term future. The Administration believes that this Act could well ease the planning task. Airline service will be stable. The air transportation system will continue to grow and evolve to meet developing public needs. Airport and airway planning will be required to reflect, as they do today, public needs. Reliance on competitive market forces rather than regulators' perceptions will allow a better air system to evolve -- responsive to the public need and with less regulatory lag.

The contention that a lessening of economic controls will result in erratic service reflects a lack of perspective or unfamiliarity with unregulated markets. Most industries are not regulated yet they provide stable and dependable service at known prices. They do so because it is in their self interests to supply orderly and dependable service. A direct comparison can also be made with intrastate airlines and airport concession holders. They are not regulated by the Board and they make long-run commitments for airport facilities. Indeed the experience of intrastate airlines strongly suggests that the reduction of federal regulation would result in more extensive use of airports. In both California and Texas there is far greater flight frequency than in comparable interstate markets.

The regulatory system has not provided stability and continuity of service on which airport operators can base long range plans. Regulated carriers have discontinued service at many airports. Of the 543 points served by regulated air carriers in 1963, only 394 now receive certificated service. In most of the abandoned points commuter airlines stepped in and provided service after the regulated carriers left. Thus, airports receive air service only if there is an economic demand for the service. Airport operators will be able to plan and finance airport facilities for which there is an economic demand. They are not protected by the regulatory system.

This concludes my written statement. I would be happy to try and respond to any questions you might have.

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